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No. 97-766

# In the Supreme Court of the United States

OCTOBER TERM, 1997

HARBOR BANCORP & SUBSIDIARIES, ET AL.,
PETITIONERS

*v.*

COMMISSIONER OF INTERNAL REVENUE

*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT*

## BRIEF FOR THE RESPONDENT IN OPPOSITION

SETH P. WAXMAN
*Solicitor General*
LORETTA C. ARGRETT
*Assistant Attorney General*
RICHARD FARBER
EDWARD T. PERELMUTER
*Attorneys*
*Department of Justice*
*Washington, D.C. 20530-0001*
*(202) 514-2217*

## QUESTION PRESENTED

Whether the interest received by petitioners on bonds issued by the Housing Authority of Riverside, California, is excluded from their gross income because the bonds are not "arbitrage bonds" under Section 148(f) of the Internal Revenue Code, 26 U.S.C. 148(f).

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### OPINIONS BELOW

The amended opinion of the court of appeals (Pet. App. A26-A50) is reported at 115 F.3d 722. The opinion of the Tax Court (Pet. App. A51-A104) is reported at 105 T.C. 260.

### JURISDICTION

The judgment of the court of appeals was entered on August 6, 1997. A petition for rehearing was denied on August 20, 1997. Pet. App. A105. The petition for a writ of certiorari was filed on November 3, 1997. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

## STATEMENT

1. Interest received by the holders of bonds issued by state or local governments is ordinarily excluded from the federal income tax. 26 U.S.C. 103(a). Since 1986, however, the Internal Revenue Code has expressly provided that interest received on such bonds *is* subject to federal tax if the bond is an "arbitrage bond (within the meaning of Section 148)" of the Code. 26 U.S.C. 103(b)(2). An "arbitrage bond" is defined in Section 148 to include a bond with respect to which the issuer fails to pay to the United States the excess of the amount earned on "all nonpurpose investments" over the amount which would have been earned "at a rate equal to the yield on the issue" (26 U.S.C. 148(f)(1),(2)). A "nonpurpose investment" is "any investment property" that is "acquired with the gross proceeds of an issue, and * * * is not acquired in order to carry out the governmental purpose of the issue." 26 U.S.C. 148(f)(6)(A).

2. In late 1985, the County of Riverside, California, authorized its Housing Authority to issue bonds to finance the construction of two multifamily housing projects known as the Whitewater and Ironwood Projects (Pet. App. A28).[1] These projects were to be developed by a private corporation (SBE Development, Inc.) under a "conduit" financing plan. A "conduit" plan is one under which the public issuer of the bonds is to channel the funds to a private entity for a public purpose (*id.* at A28-A29).

In an effort to qualify the bonds for tax exempt treatment under 26 U.S.C. 103(a), a plan was

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[1] The bonds issued for the Whitewater project were to total $17.2 million, and the bonds for the Ironwood project totalled $13 million (Pet. App. A56-A57).

formulated that involved an intricate arrangement among multiple parties. The Housing Authority was to issue the bonds through two underwriters, Donaldson, Lufkin & Jenrette Securities and Drexel, Burnham, Lambert, Inc.[2] The proceeds were to be deposited in a "Developer Loan Fund" at a trustee bank (Interfirst Bank of Houston) for use by SBE Development in exchange for a note from the developer (Pet. App. A54). As security for the note, SBE Development was to obtain irrevocable letters of credit (to be deposited in a "Debt Service Fund" at Interfirst Bank) from two entities that were to be formed solely for the purpose of providing letters of credit for the projects (*id.* at A55). The letter of credit provider for the Whitewater project was named Mercantile Capital Finance Corp. No. 47 (MCFC No. 47) and the letter of credit provider for the Ironwood project was named Mercantile Capital Finance Corp. No. 30 (MCFC No. 30) (*ibid.*). The sole shareholder of these two corporations was James J. Keefe (*ibid.*). In exchange for the letters of credit, SBE Development was to provide the MCFC entities with reimbursement notes that paid interest at the rate of interest on the bonds and were secured by a mortgage on the property to be developed (*ibid.*).

Because the MCFC corporations were single-purpose entities and lacked significant capitalization, the letters of credit to be issued by them were not sufficient security for repayment of the bonds. The parties therefore contemplated that the MCFC corporations would sell the reimbursement notes (at a

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[2] Drexel's role was limited from the outset, and it eventually dropped out of the underwriting activity on the projects (Pet. App. A30).

discount) to Unified Capital Corp., an entity that was also owned in part by Keefe (Pet. App. A55). The MCFC corporations were then to use the cash obtained from Unified Capital to purchase two "guaranteed investment contracts" from a reliable financial institution that would pay interest at rates above the interest rates on the bonds (*ibid.*).[3] These "guaranteed investment contracts" were to secure all payments of principal and interest coming due under the letters of credit.

3. a. In December 1985, SBE Development executed "Deposit Agreements" that gave control over the bond proceeds to Unified Capital (Pet. App. A33). SBE Development made these agreements on the understanding that Unified would thereafter disburse the money as required for project purposes (*ibid.*). The Riverside Housing Authority was not informed of the existence of the deposit agreements (*ibid.*).

A closing for the Whitewater and Ironwood bond issues was scheduled for December 31, 1985. The bonds were not, however, to be marketed to the public at that time. Instead, they were to be marketed sometime in 1986, after they had been rated by Standard & Poor's Corp. (Pet. App. A58-A59). The December 31 closing date was chosen in an effort to avoid a change in the tax law that Congress had enacted to impose new and more restrictive "arbitrage bond" rules for governmental bonds issued after December 31, 1985 (*id.* at A29).

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[3] The yield on the bonds was 7.3750 percent for the Whitewater project and 7.66652 percent for the Ironwood project (Pet. App. A76). The yield on the "guaranteed investment contracts" was 9.5520 percent (*ibid.*).

b. Shortly before the scheduled closing date, the investment banker who was handling this project for the underwriting firm of Donaldson, Lufkin and Jenrette learned that his firm was financially unable to bring the Whitewater and Ironwood bonds to market due to the large number of bond closings scheduled for December 31, 1985 (Pet. App. A58). He then contacted Arthur Goldberg, vice president at the investment banking firm of Matthews & Wright, Inc., to determine if that firm could act as a substitute underwriter (*ibid.*). Goldberg agreed that Matthews & Wright would take over as underwriter of the Whitewater and Ironwood bond issues (*ibid.*).

c. In addition to his duties at Matthews & Wright, Goldberg headed a credit institution located in Jersey City, New Jersey, named the New American Federal Credit Union (Pet. App. A59). On December 31, 1985, Goldberg instructed the general manager of New American to bring "starter kit" books of the credit union's share drafts (the functional equivalent of checks) to the offices of Matthews & Wright (*ibid.*). At what purported to be a "closing" on that date, Goldberg executed share drafts from the "starter kits" for the purported (but nonexistent) accounts of off-shore entities in exchange for what purported to be issuances of the bonds (*id.* at A31). On that same date, Goldberg repeated this same purported "closing" for numerous other transactions on behalf of Matthews and Wright, utilizing "starter kits" to issue share drafts on nonexistent accounts for "a total of some $750 million, or about 15 times the credit union's assets" (*ibid.*).

Neither Matthews & Wright nor New American had sufficient funds to cover the share drafts (Pet. App. A31). The transactions by Goldberg on

December 31, 1985, accomplished nothing of substance: a circular check kiting scheme occurred in which the share drafts ostensibly used to purchase the Whitewater and Ironwood bonds were drawn on nonexistent accounts of off-shore entities and were then held outside of banking channels by Matthews & Wright (*id.* at A60).[4]

d. On February 20, 1986, Matthews & Wright borrowed approximately $58 million from Security Pacific National Bank (Pet. App. A63). Some of this money was wire transferred to Chase Manhattan Bank for the account of New American (*ibid.*), from which it was transferred to Heritage National Bank of Austin, Texas (*ibid.*). Heritage then deposited $17,778,146.53 in an account opened in the name of Whitewater, Ltd. (*ibid.*). This amount was again immediately transferred to an account in the name of Unified Capital at Heritage (*ibid.*).

On February 20, 1986, Unified Capital made several disbursements from this account, including fees paid to itself (Pet. App. A64). Unified Capital also transferred $16,110,817.98 to another account at Heritage for MCFC No. 47 (*ibid.*). MCFC No. 47 used this amount to purchase a "guaranteed investment contract" from Crown Life Insurance Company

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[4] The circular check scheme included the participation of an entity named "Commercial Bank of the Americas, Ltd.," which was ostensibly located on the island of Saipan in the Northern Mariana Islands. The Commercial Bank of the Americas had lost its banking charter prior to the date of the purported closing (Pet. App. A59). The entire assets of Commercial Bank on that date, when it purportedly purchased $31 million of bonds in this transaction, were $5,011 (*id.* at A60). The circular check scheme employed by Goldberg is described in detail in the opinions below (*id.* at A30-A32, A59-A60).

(*ibid.*). The payments yielded by the investment contract equalled the debt service required to pay interest as it came due on the Whitewater bonds (*id.* at A65). MCFC No. 47 pledged the investment contract to Interfirst Bank, thereby allowing the trustee bank to make scheduled payments to the bondholders (*ibid.*).

e. A similar transaction occurred with respect to the Ironwood bonds on February 20, 1986. On that date, Heritage deposited $12,190,843.34 in an account opened in the name of Ironwood, Ltd. That sum was then again immediately transferred to an account of Unified Capital at Heritage (Pet. App. A64). Unified Capital transferred $11,047,408.05 of this amount to an account for MCFC No. 30 at Heritage (*ibid.*). MCFC No. 30 used this amount to purchase a "guaranteed investment contract" from Crown Life Insurance Company (*ibid.*). The payments yielded by the investment contract equalled the debt service required to pay interest as it came due on the Ironwood bonds (*id.* at A65). MCFC No. 30 pledged the investment contract to Interfirst Bank, thereby allowing the trustee bank to make scheduled payments to the bondholders (*ibid.*).

f. Because of the manner in which these transactions were executed, the sums invested in the "guaranteed investment contracts" were not available for construction of the Whitewater and Ironwood proj ects (Pet. App. A64). As the result, the Whitewater project was never constructed. The Ironwood project was completed several years later, after SBE Development obtained a commercial construction loan from a savings and loan association (*id.* at A65-A66).

4. In July 1986, petitioners acquired Whitewater and Ironwood bonds (Pet. App. A66). Petitioners ex-

cluded the interest they received on those bonds from gross income on their federal income tax returns (*id.* at A67). After investigating the circumstances surrounding the issuance of the Whitewater and Ironwood bonds, however, the Internal Revenue Service determined (i) that the bonds were not issued until 1986 and were therefore subject to the statutory limitations on "arbitrage bonds" in Section 148 of the Internal Revenue Code and (ii) that the investment of the bond proceeds in the higher yielding "guaranteed investment contracts" brought the bonds within the definition of "arbitrage bonds" that are subject to federal income tax under that Section.

The Service informed the Housing Authority that, under Section 148(f)(2), interest paid on the bonds must be treated as taxable income to the bondholders unless the issuer pays to the United States the excess of the yield of the guaranteed investment contract (the "nonpurpose investment") over the "yield on the issue" (26 U.S.C. 148(f)(2)). The Service calculated that amount to be $3.8 million in this case (Pet. App. A67). When the issuer refused to make this payment, the Service asserted deficiencies in tax against petitioners for the relevant taxable years (*id.* at A51-A52).

5. a. Petitioners sought review of the Commissioner's determinations in the Tax Court. Petitioners claimed that the Whitewater and Ironwood bonds were not "arbitrage bonds" under Section 148(f) for two reasons. First, petitioners asserted that the bonds were "issued" for federal tax purposes on December 31, 1985, one day before the effective date of the statute. In the alternative, petitioners asserted that Section 148(f) applies only to "nonpurpose investments" made by the issuer of the bond and that the

Whitewater and Ironwood bond proceeds had been invested in the higher yielding "guaranteed investment contract" by a nonissuer who was acting without authority in doing so.

b. In a reviewed opinion joined in by 14 judges (with three judges concurring and one in dissent), the Tax Court upheld the Commissioner's determination that the income from these bonds is not tax exempt because they are "arbitrage bonds" within the meaning of 26 U.S.C. 148(f). The court first held that the putative "closing" that occurred on December 31, 1985, was an obvious sham that lacked economic substance (Pet. App. A68-A69). The court concluded that "the date of issue of the Bonds was not December 31, 1985, but rather February 20, 1986, when actual funds were transferred from Security Pacific Bank * * * to purchase the bonds" (*id.* at A69). The court then held that, under the plain text of Section 148(f), the bonds were "arbitrage bonds" because (i) the bond proceeds were invested in guaranteed investment contracts that were "nonpurpose investments" and (ii) the amount earned on those contracts exceeded the amount that would have been earned if the bond proceeds had been invested at the yield rate on the bonds (*id.* at A69-A84).

The court rejected petitioners' contention that Section 148(f) is inapplicable because neither the Housing Authority nor the designated private developer (SBE Development) made the decision to invest the bond proceeds in the "guaranteed investment contracts." The court pointed out that, unlike other provisions concerning "arbitrage bonds" in Section 148, the restrictions established by Congress in Section 148(f) do not turn on whether the issuer itself intends

to or does profit from arbitrage bonds (Pet. App. A71-A72).

6. The court of appeals affirmed (Pet. App. A26-A50).[5] The court described in careful detail the evidence that supported the finding of the Tax Court that the purported closing on December 31, 1985, was merely a "sham" that lacked economic substance (*id.* at A35-A41). Based upon this evidence, the court held that "[t]he Tax Court was entitled to find that the December 31 transactions weren't real, and that the bonds were actually issued February 20, 1986" (*id.* at A41). The court therefore agreed with the Tax Court that the "arbitrage bond" provisions of Section 148 apply to the bonds involved in this case (*ibid.*).

The court of appeals then held that the bonds issued by the Housing Authority were "arbitrage bonds" under that statute (Pet. App. A41-A50). Unlike the Tax Court, the court of appeals believed the language of the statute to be ambiguous "as applied in this case" (*id.* at A45-A46, A49). The court held, however, that, among the competing alternatives, the Commissioner's interpretation of Section 148(f) was the most "persuasive construction of [this] complex provision of the Tax Code" (*id.* at A50). The court noted that the Commissioner's interpretation of the statute (*id.* at A50):

> will encourage bond issuers to maintain tight control over the proceeds, and will protect federal taxpayers from having to subsidize unapproved,

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[5] The original opinion of the court of appeals (Pet. App. A1-A25) was issued on June 10, 1997. In response to a petition for rehearing filed by petitioners, the court of appeals issued an amended opinion on August 6, 1997 (*id.* at A26-A50).

non-governmental uses of tax-free state and municipal obligations.

## ARGUMENT

The court of appeals correctly held that the bonds involved in this case are "arbitrage bonds" within the meaning of 26 U.S.C. 148(f) and that the interest that petitioners received on those bonds is therefore not excluded from their gross income. The decision of the court of appeals does not conflict with any decision of this Court or any other court of appeals. Indeed, as petitioners acknowledge (Pet. 19), this is a case of first impression. Further review is therefore not warranted.

1. a. The interest received by a private investor on any "arbitrage bond" issued by a state or local government is not excluded from federal income tax. 26 U.S.C. 103(b)(2). Under Section 148 of the Internal Revenue Code, bonds issued by state or local governments are treated as "arbitrage bonds" in three situations: (i) if, at the time of issuance, any portion of the proceeds is "reasonably expected" to be used to acquire higher yielding investments (26 U.S.C. 148(a)), (ii) if, subsequent to the date of issuance, the issuer intentionally uses any portion of the proceeds to acquire higher yielding investments (*ibid.*) and (iii) if, in any event, the proceeds are invested in higher yielding investments that are not related to the governmental purpose of the bond ("nonpurpose investments") and the issuer does not pay the United States the difference between the yield on that investment and the yield on the bond (26 U.S.C. 148(f)(2)). In the first two situations, bond interest is taxable retroactive to the date the bonds are issued, and the issuer may not cure the defect by paying the

arbitrage amount to the United States. See S. Rep. No. 313, 99th Cong., 2d Sess. 845 (1986). In the third situation, interest received by bondholders is also taxable retroactive to the date of issue if the issuer does not pay the arbitrage amount to the United States under the procedures of Section 148. See 26 U.S.C 148(f)(3).

The courts below correctly held that the Whitewater and Ironwood bonds are "arbitrage bonds" under this statute. An "arbitrage bond" exists under Section 148(f) if (i) the gross proceeds of the issue are invested in a "nonpurpose investment," (ii) the nonpurpose investment earns a higher rate of return than the yield rate on the bond and (iii) the issuer does not pay the arbitrage amount to the United States. The term "nonpurpose investments" is defined as "any investment property which is acquired with the gross proceeds of an issue and is not acquired in order to carry out the governmental purpose of the issue." 26 U.S.C. 148(f)(6)(A)(i) and (ii). The term "investment property" includes "any obligation," "any annuity contract" and "any investment-type property." 26 U.S.C. 148(b)(2)(B), (C) and (D).

The proceeds of the Whitewater and Ironwood bonds were unquestionably invested in "nonpurpose investments" as that term is expressly defined, since the guaranteed investment contracts were not acquired to carry out the governmental purpose of constructing multifamily housing. See page 7, *supra*. It is also evident that the amounts earned on those investment contracts substantially exceeded the amounts that would have been earned if the bond proceeds had been invested at the yield rate of the bonds (Pet. App. A74-A77). See note 3, *supra*. Finally, it is undisputed that the bond issuer did not pay the arbitrage amount to

the United States. For the reasons explained in detail by the Tax Court (Pet. App. A69-A84), the Whitewater and Ironwood bonds are thus "arbitrage bonds" under the plain text of Section 148(f). The interest received by petitioners on those bonds is therefore not exempt from taxation. As this Court emphasized in *Hubbard* v. *United States*, 514 U.S. 695, 703 (1995), quoting *BFP* v. *RTC*, 511 U.S. 531, 570 (1994) (Souter J., dissenting), "absent any 'indication that doing so would frustrate Congress's clear intention or yield patent absurdity, our obligation is to apply the statute as Congress wrote it.'"

b. The court of appeals reached the same conclusion, but by a different route. The court of appeals held that the statute is not unambiguous as applied to this case, in which the "nonpurpose investment" was made by an entity that obtained the proceeds of the bond from the issuer and was not made by the issuer itself (Pet. App. A45-A46). The court concluded, however, that the interpretation advanced by the Commissioner is the more persuasive of the alternative constructions because it advances the purpose of the statute to restrain misapplication of tax-exempt fundings (*id.* at A50).

Petitioners contend (Pet. 13-19) that the court of appeals erred by construing an "ambiguous" tax provision against the taxpayer.[6] It is well established,

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[6] Petitioners also object to portions of the original decision of the court of appeals that were deleted by that court in response to the petition for rehearing. Compare Pet. 18 ("the court was required to make its own analysis") with Pet. 7 (the amended opinion "deleted most of the express indications of deference to the Commissioner"). It is obviously the amended opinion—not the original opinion which was withdrawn—that constitutes the decision in this case. The grievances that peti-

however, that statutes governing exclusions from income are to be strictly construed in favor of the government.[7] *Commissioner* v. *Schleier*, 515 U.S. 323, 328 (1995); *United States* v. *Centennial Savings Bank FSB*, 499 U.S. 573, 583-584 (1991); *Commissioner* v. *Jacobson*, 336 U.S. 28, 49 (1949). The provisions of Section 148(f) operate, in coordination with Section 103(b)(2), to determine whether income received from state and local bonds is excluded from tax. See 26 U.S.C. 103(b)(2). As both courts below correctly observed, that statute is therefore to be interpreted strictly in favor of the government in this case (Pet. App. A45, A83-A84).[8]

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tioners continue to urge against the original opinion of the court of appeals became moot when that decision was withdrawn.

[7] The "overwhelming authority" on which petitioners rely (Pet. 19) for the opposite proposition is inapposite. The cases that petitioners cite do not involve the rule of statutory interpretation that applies to exclusions from income.

[8] The court of appeals properly rejected the reliance that petitioners seek to place on the legislative history of Section 148 (Pet. 15). The court correctly observed that the legislative history is "unilluminating" and does not "help clarify whether Congress intended nonpurpose investments under § 148(f) to include ones that the bond issuer neither makes nor benefits from" (Pet. App. A47).

Petitioners' contention that the word "rebate" in Section 148(f) mandates the conclusion that the issuer must have actual possession of the arbitrage amount is also unsupported. As the court of appeals correctly stated (Pet. App. A45), common definitions of the word "rebate" reflect "that a rebater needn't always possess the rebated funds in the first place." The decision of *City of Columbus* v. *Commissioner*, 112 F.3d 1201 (D.C. Cir. 1997), which petitioners cite (Pet. 15-16), is inapposite. That case did not involve Section 148(f) and the

There is no conflict among the circuits nor other reason to warrant review by this Court of the application of this settled principle to the particular "complex provision of the Tax Code" (Pet. App. A50) involved in this case.

c. The contention of petitioner that the decision in this case has "ominous" implications for the municipal bond market (Pet. 19) lacks any foundation. This decision will not adversely affect legitimate municipal bond issues. It will, instead, benefit the bond market by providing incentive for issuers to maintain adequate controls over bond proceeds and thereby ensure that those proceeds are used for the intended public purpose rather than to reap unsanctioned arbitrage profits. As the court of appeals explained, the interpretation of the statute adopted in this case "will protect federal taxpayers from having to subsidize unapproved, non-governmental uses of tax-free state and municipal obligations" (Pet. App. A50).

2. Section 148 applies to bonds issued after December 31, 1985. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1314(d)(1), 100 Stat. 2664. Petitioners contend (Pet. 8-12) that Section 148(f) does not apply to this case because the bonds were "issued" for federal tax purposes on December 31, 1985, the day before the statute became effective. The Tax Court correctly found (Pet. App. A68-A69), however, that the purported closing of the bonds on December 31, 1985, was an obvious sham that should be disregarded for federal tax purposes. That finding was affirmed by the court of appeals (*id.* at A40-A41). That factual determination, concurred in by both courts below,

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court in *City of Columbus* neither considered nor addressed the questions presented in this case.

does not warrant review by this Court. See *Tiffany Fine Arts, Inc.* v. *United States*, 469 U.S. 310, 317 n.5 (1985).

The Tax Court was amply justified in concluding that the purported closing was a sham. The date that a bond is issued is the date on which the evidence of indebtedness is exchanged for the issue price. See 26 C.F.R. 1.103-13(b)(6) (1979); 26 C.F.R. 1.150-1(c)(2) (1992). As the Tax Court found, the record of this case reflects that the putative purchaser of the bonds lacked even a meaningful portion of the funds required to purchase the bonds on the scheduled closing date and, with the acquiescence of the other parties, presented worthless share drafts drawn on "starter kit" forms from nonexistent accounts as "payment" for the bonds. The record also shows that the bogus share drafts were never placed into the banking channels and were instead passed in circular fashion among the parties to return to the hands of the underwriter (Pet. App. A59-A60). At the conclusion of the purported "closing," the issuers had plainly not received bona fide payment for the bonds.

In these circumstances, the Tax Court properly determined that the "closing" was a sham that must be disregarded for tax purposes. As this Court has frequently emphasized, the incidence of taxation is determined by the substance, not the form, of the transaction. See, *e.g.*, *Commissioner* v. *Tower*, 327 U.S. 280, 291 (1946); *Commissioner* v. *Court Holding Co.*, 324 U.S. 331, 334 (1945). The court of appeals followed that established rule in this case (Pet. App. A39).

Petitioner asserts that the mere existence of tax-avoidance motives does not make the transaction a sham (Pet. 11-12, citing *Frank Lyon Co.* v. *United*

*States*, 435 U.S. 561 (1978)).[9] But it was not the mere existence of tax-avoidance motives on which the courts below relied: it was the entire, convoluted scheme of circular flows of meaningless checks drawn on "starter kits" for nonexistent accounts that revealed that the transactions at issue in this case were a sham. Petitioners have not cited any case suggesting that a party may receive tax benefits simply by distributing worthless checks as part of a circular transaction. Indeed, this Court in *Frank Lyon Co.* emphasized that it would not "condon[e] manipulation by a taxpayer through arbitrary labels and dealings that have no economic significance." 435 U.S. at 583. As the court of appeals explained, there is ample and consistent precedent for the proposition that a taxpayer "may not receive tax benefits based on checking arrangements that lack economic substance" (Pet. App. A38-A39, citing cases).

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[9] The case that petitoners cite did not concern whether a worthless check should be treated as if it were a substantive transaction for tax purposes. The issue before the Court in *Frank Lyon Co.* was the validity for federal tax purposes of a sale-leaseback arrangement.

## CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

SETH P. WAXMAN
*Solicitor General*
LORETTA C. ARGRETT
*Assistant Attorney General*
RICHARD FARBER
EDWARD T. PERELMUTER
*Attorneys*

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